Pass cards

ACCA Paper F3
Financial Accounting (International Stream)

BPP LEARNING MEDIA

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Good luck!

Page

1: Introduction to accounting

Topic List

- The purpose of financial reporting
- Types of business entity
- Users
- The main financial statements

This chapter looks at why financial statements are prepared, the different types of business entity and the users of financial statements.

We also look at the main financial statements: the statement of financial position (balance sheet) and the income statement.

The purpose of financial reporting

A business has a number of functions, the most prominent is to make a profit for the owners

↓

Profit is the excess of income over expenditure

Types of business entity

Sole traders – refers to ownership, sole traders can have employees

Partnerships – two or more people working together to earn profits

Limited liability company – owners have liability limited to the amount they pay for their shares

– a limited liability company has a separate legal identity from its owners

Users of accounts

- Managers of the company
- Shareholders of the company
- Trade contacts
- Providers of finance to the company
- Taxation authorities
- Employees of the company
- Financial analysts and advisors
- Government and their agencies
- The public

The larger the entity, the greater the interest from various groups of people.

Entity concept

The entity is treated as separate from its owners

- The entity owns the cash invested
- The entity owes this cash to the owner (capital)

Asset

Something valuable which an entity owns or has use of

- A factory or warehouse
- Inventories for resale
- Cash

Liability

Something owed to somebody else

- Bank loan
- Amounts owed to suppliers
- Taxation owed to government

The balance sheet

is a list of assets, liabilities and capital of a business at a given moment

HAPPINESS
BALANCE SHEET AS AT 31 AUGUST 20X1

Assets		
Non-current assets at NBV	**$**	**$**
Freehold premises		100,000
Fixtures and fittings		16,000
Motor vehicles		18,000
		134,000
Current assets		
Inventories	10,000	
Receivables	23,000	
Prepayments	100	
Cash	700	
		33,800
Total assets		167,800

Under IAS 1 (revised), the balance sheet is now known as the statement of financial position.

Equity and liabilities		
Equity		
Capital as at 1 September 20X0		95,200
Profit for the year		16,000
		111,200
Less drawings		(8,000)
Capital as at 31 August 20X1		103,200
Non-current liabilities		
Loan		50,000
Current liabilities		
Bank overdraft	4,000	
Accounts payable	3,600	
Taxation payable	7,000	
		14,600
		167,800

Capital + liabilities = assets

Main financial statements

Statement of financial position (balance sheet)

A list of assets owned by the entity and liabilities owed by the entity on a particular date

- Total assets = Total liabilities
- Amount invested by owner is **capital**

Income statement

A record of income generated and expenditure incurred over a given period

Accruals concept

The financial statements are prepared on an accruals basis

A sale or purchase is dealt with in the period it is made, even if cash changes hands later than this

Non-financial statements may be required under local legislation.

The income statement

matches revenue earned in a period with the costs incurred in earning it

Gross profit = sales – cost of sales

Net profit = gross profit – expenses

HAPPINESS – INCOME STATEMENT
FOR THE YEAR ENDED 31 AUGUST 20X1

	$	$
Sales		80,000
Opening inventory	5,000	
Purchases	40,000	
Closing inventory	(10,000)	
Cost of goods sold		35,000
Gross profit		45,000
Less expenses		
Rent	12,000	
General expenses	4,000	
Wages	12,000	
Depreciation	1,000	
		29,000
Net Profit		16,000

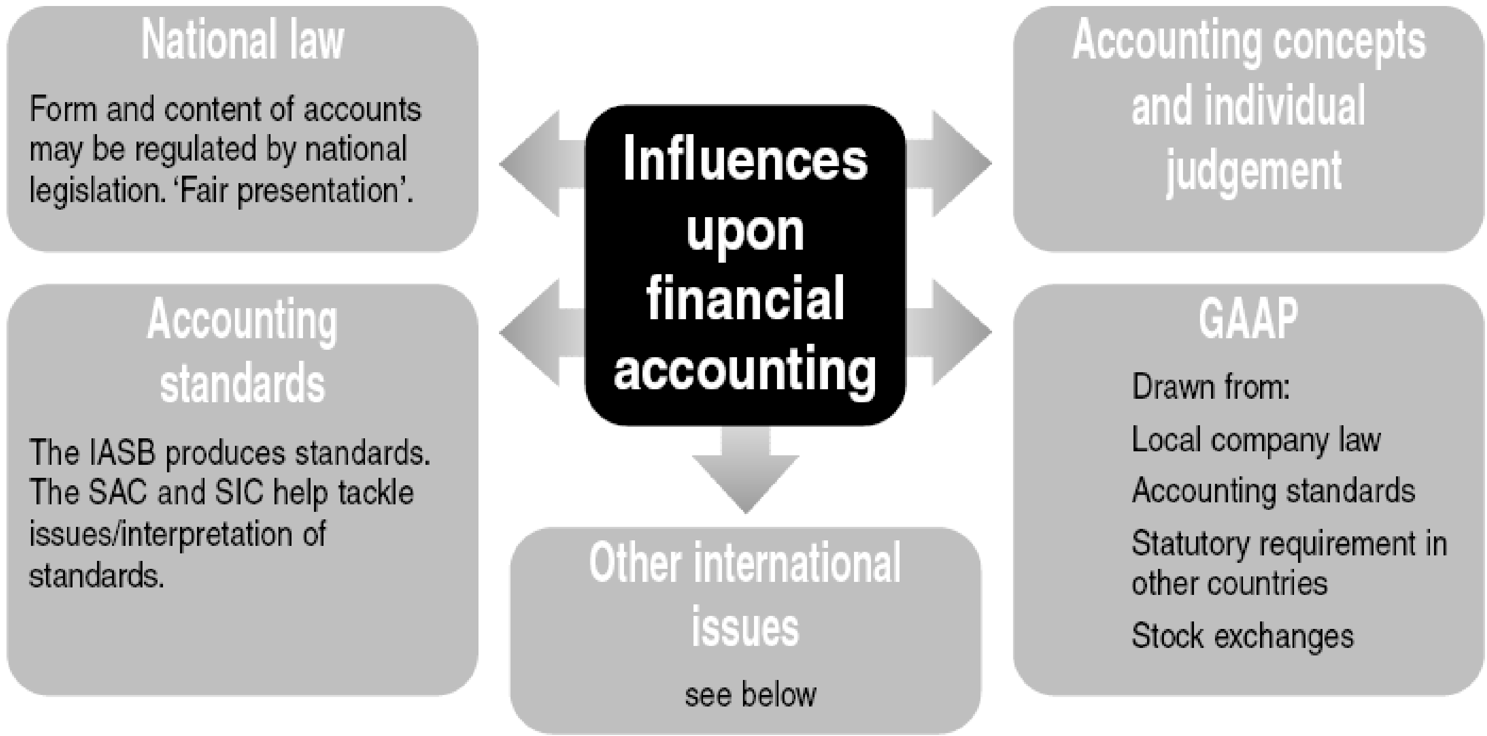
2: The regulatory framework

Topic List

The regulatory system

IASB

This is a look at the regulatory system and the role played by the IASB.


National law
Form and content of accounts may be regulated by national legislation. ‘Fair presentation’.
Accounting standards
The IASB produces standards. The SAC and SIC help tackle issues/interpretation of standards.
Influences upon financial accounting
Other international issues
see below
Accounting concepts and individual judgement
GAAP
Drawn from:
Local company law
Accounting standards
Statutory requirement in other countries
Stock exchanges

International influences

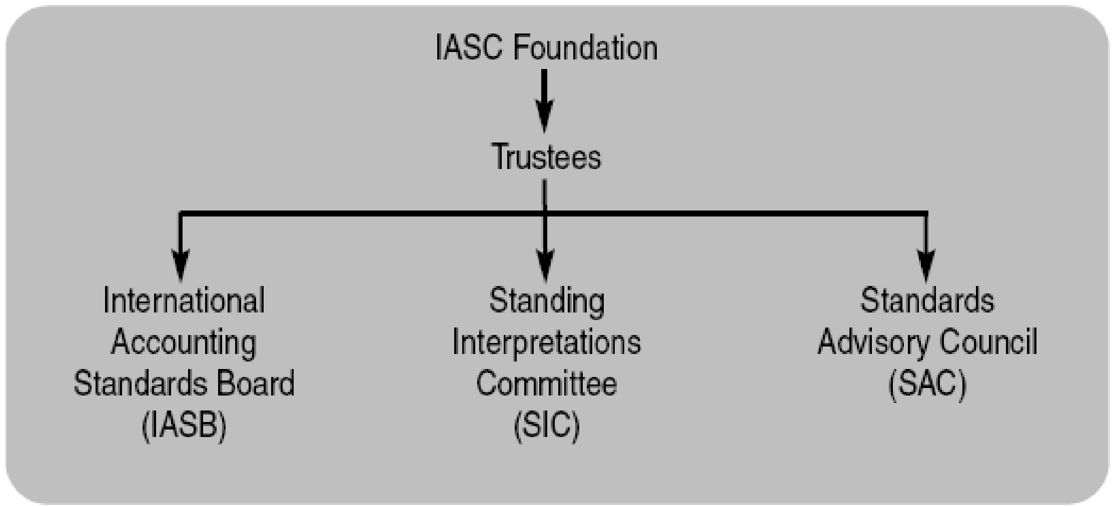
EU	IFAC
UN	OECD

The international influence on European accounting is very important. All listed companies in the UK now have to prepare their consolidated accounts under International Financial Reporting Standards.

Treatments in IASs/IFRSs

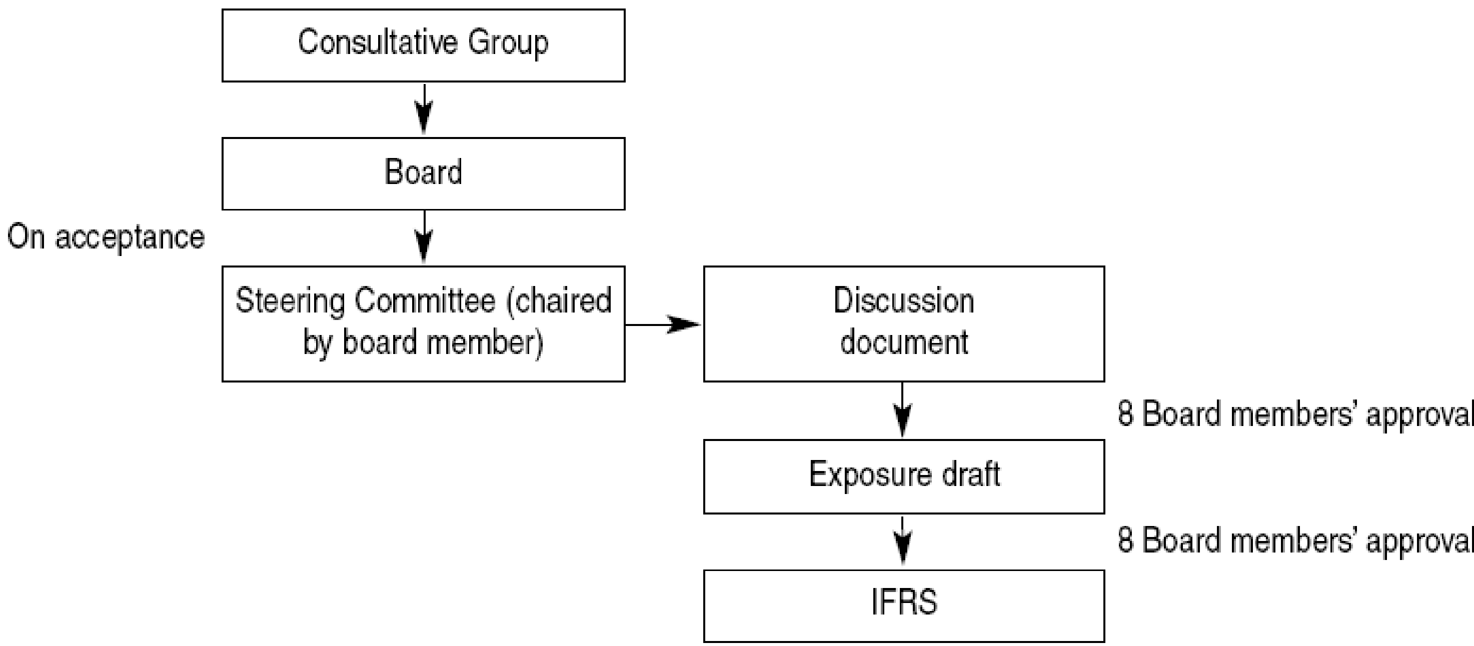
A number of accounting standards gave preparers of accounts a choice of accounting treatments – the 'benchmark' treatment and the 'allowed alternative'. Most of these standards have now been revised to remove this choice. There is now much more **standardisation** of accounting treatment.

Financial statements must give a 'true and fair view' or 'present fairly' the entity's financial position.


IASC Foundation
Trustees
International Accounting Standards Board (IASB)
Standing Interpretations Committee (SIC)
Standards Advisory Council (SAC)

Standard setting process

The procedure can be summarised as follows.



3: Accounting conventions

Topic List

- Background
- IAS 1
- The IASB's Framework
- Criticisms
- Bases of valuation
- IAS 8

Modern accounting is based on certain concepts and conventions.

Get to grips with these and you should be well equipped to discuss accounting standards and their strengths and weaknesses.

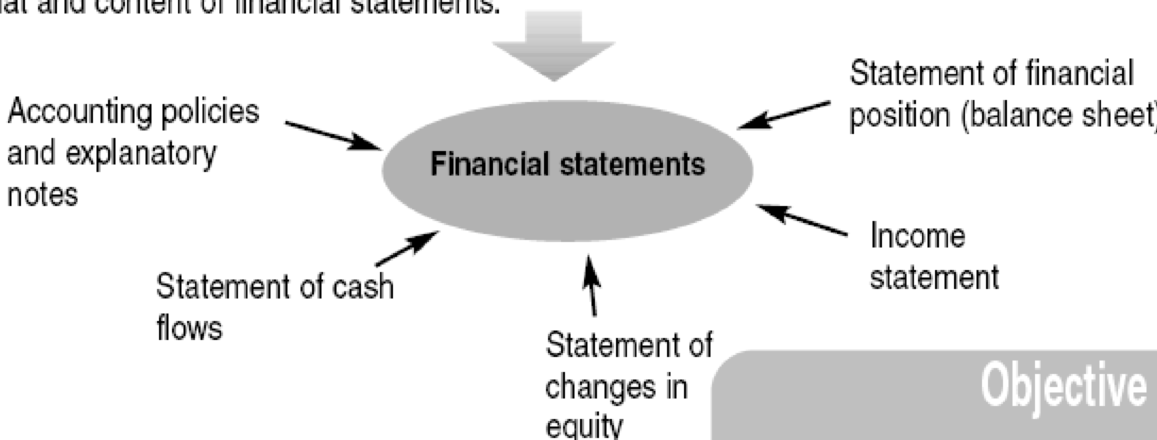
Background

Accounting policies have developed over the centuries. They are based on generally accepted concepts.

- Fair presentation
- Going concern
- Accruals or matching
- Consistency
- Prudence
- Materiality
- Substance over form

- Relevance
- Reliability
- Faithful representation
- Neutrality
- Completeness
- Comparability
- Understandability

IAS 1 *Presentation of financial statements* considers accounting policies, fundamental assumptions and the format and content of financial statements.



Directors are also encouraged to prepare a **financial review** and any other reports or statements which may aid users.

Objective

To prescribe the basis for presentation of general purpose financial statements, in order to ensure comparability both with the entity's own financial statements of previous periods and with the financial statements of other entities.

Financial statements should *present fairly* financial performance, financial position and cash flows. Compliance with IASs will help to ensure this.

Going concern

The entity will continue in operation for the foreseeable future. There is no intention to put the entity into liquidation or to make drastic cutbacks to the scale of the operations.

Consistency

The presentation and classification of items should stay the same from one period to the next.

Accruals

Revenue and costs must be recognised as they are earned or incurred, not as money is received or paid. They must be matched with one another so far as the relationship can be established or justifiably assumed and dealt with in the I/S in which they were incurred.

Materiality

Information is material if its omission or misstatement could influence the economic decisions of users.

Prudence

The inclusion of a degree of caution in the exercise of judgement, such that assets or income are not overstated and liabilities or expenses are not understated.

Substance over form

Transactions and other events are accounted for and presented according to their substance and not just their legal form.

Fair presentation:	compliance with IFRSs should be disclosed
Relevance:	information provided satisfies needs of users
Reliability:	information is free from material error or bias
Faithful representation:	only recognised if financial effects are certain
Neutrality:	information must be free from bias
Completeness:	information gives rounded picture
Comparability:	consistent basis used so valid comparison can be made with other periods
Understandability:	information may be difficult to understand if it is incomplete, but too much detail can confuse

Good accounting information has the following qualities

- Relevance
- Understandability
- Reliability
- Comparability
- Objectivity
- Timeliness
- Completeness

The four **principal** qualitative characteristics defined by the IASB *Framework* are:

- Relevance
- Reliability
- Understandability
- Comparability

Criticisms

Some criticisms have been made of financial accounts. They include the following.

- Accounts are becoming more complex, containing material which is:
  - Not applicable to small companies
  - Incomprehensible to the layman
- Information prepared for external reporting purposes is not generally useful for internal decision making purposes
- Financial statements do not necessarily give a good indication of the suitability of the company for investment and the likelihood of its future success
- Conventional financial statements do not always provide users with the kind of information they want
- The historical cost convention, under which financial statements are still prepared, may be misleading

Bases of valuation

Historical cost

means that transactions are recorded at the cost when they occurred.

Net realisable value

means the estimated selling price less the estimated costs of completion and the estimated costs to make the sale.

Replacement cost

means the amount needed to replace the asset with an identical asset.

Economic value

means the amount of the profits an asset is expected to generate during its remaining life.

Criticisms of historical cost accounting

Historical cost accounting can be misleading for the following reasons.

- Non-current asset values are unrealistic
- Depreciation is inadequate to finance purchase of new assets
- Holding gains on inventories are included in profit
- Profits (or losses) on holdings of net monetary items are not shown
- The true effect of inflation on capital maintenance is not shown
- Comparisons over time are unrealistic

IAS 8 Accounting policies, changes in accounting estimates and errors

You should know the definitions of the following:

- Prospective application
- Retrospective application
- Prior period errors
- Accounting policies

Correction of prior period errors and changes of accountancy policy require *retrospective* application.

4: Sources, records and books of prime entry

Topic List

- The role of source documents
- Sales and purchase day books
- Cash books

This chapter covers the main sources of data and the function each source or record has.

We will see how the documents are recorded in books of original entry to reflect business transactions.

Source documents

Business transactions are nearly always recorded on a document. These documents are the source of the information in the accounts. Such documents include the following:

- Quotation
- Sales order
- Purchase order
- Invoice
- Credit note
- Debit note
- Goods received note

Books of prime entry

The source documents are recorded in books of prime entry.

Journal

Journals are used to record source information that is not contained within the other books of prime entry. They record the following:

- Period end adjustments
- Correction of errors
- Large / unusual transactions

Sales day book

The sales day book is used to keep a list of all invoices sent out to customers each day. Here is an example.

SALES DAY BOOK

Date	*Invoice number*	*Customer*	*Rec'bles ledger ref.*	*Total invoiced*
				$
3.3.X9	207	ABC & Co	SL12	4,000
	208	XYZ Co	SL59	1,200
				5,200

Purchases day book

This is used to keep a record of invoices which a business receives. Here is an example.

PURCHASES DAY BOOK

Date	*Supplier*	*Payables ledger ref.*	*Total invoiced*
			$
3.4.X9	RST Co	PL31	215
10.4.X9	JMU Inc	PL19	1,804
15.4.X9	DDT & Co	PL24	758
			2,777

Sales and purchase returns day books summarise goods returned to/by the business.

Cash book

Cash receipts and payments are recorded in the cash book.

Cash receipts are recorded as follows, with the total column analysed into its component parts.

CASH RECEIPTS

Date	*Narrative*	*Total*	*Discounts allowed*	*Rec'bles ledger*	*Cash sales*	*Sundry*
		$	$	$	$	$
3.3.X9	Cash sale	150			150	
	Receivable:					
	ABC & Co	1,000	50	1,000		
	(discount taken)					
		1,150	50	1,000	150	–

Cash payments are recorded in a similar way.

Petty cash book

Most businesses keep a small amount of cash on the premises for small payments, eg stamps, coffee. Petty cash payments and receipts are recorded in a petty cash book.

PETTY CASH BOOK

RECEIPTS			PAYMENTS					
Date	*Narrative*	*Total*	*Date*	*Narrative*	*Total*	*Stationery*	*Coffee*	*etc*
		$	Date		$	$	$	$
3.3.X9	Bank	50	3.3.X9	Paper	10	10		
				Coffee	5		5	
		50			15	10	5	

Under the 'imprest system':

	$
Cash still held in petty cash	X
Plus voucher payments	X
Must equal the agreed sum or float	X

Reimbursement is made equal to the voucher payments to bring the float back up to the imprest amount.

5: Ledger accounts and double entry

Topic List

- The nominal ledger
- The accounting equation
- Double entry bookkeeping
- The journal and imprest system
- Day book analysis
- The receivables and payables ledgers

This chapter looks at ledger accounting.

The balances on the ledgers help provide the business with information about what it is doing.

Ledger accounting

is the process by which a business keeps a record of its transactions:

In chronological order

Built up in cumulative totals

A ledger account or 'T' account looks like this.

NAME OF ACCOUNT

	$		$
DEBIT SIDE		CREDIT SIDE	

The nominal ledger

is an accounting record which summarises the financial affairs of a business.

Accounts within the nominal ledger include the following.

- Plant and machinery (non-current asset)
- Inventories (current asset)
- Sales (income)
- Rent (expense)
- Total payables (current liability)

The accounting equation

CAPITAL + LIABILITIES = ASSETS

Capital

Investment of funds with the intention of earning a return

Drawings

Amounts withdrawn from the business by the owner

The accounting equation is based on the principle that an entity is separate from the owner.

The business equation

$$\boxed{P = I + D - C_i}$$

Key

P = profits

I = increase in the entity's net assets over a period

D = drawings

C_i = increase in capital thanks to an injection of funds by the owners

These two equations are the basis for the statement of financial position (balance sheet) and the income statement.

Understanding these will help you understand the preparation of financial statements.

Note: In your BPP Learning Media Study Text you will find the business equation in Chapter 18, as it is an important incomplete records technique.

Basic principles

Double entry bookkeeping is based on the same idea as the accounting equation.

- Every accounting transaction has two equal but opposite effects
- Equality of assets and liabilities is preserved

In a system of double entry bookkeeping every accounting event must be entered in ledger accounts both as a debit and as an equal but opposite credit.

Debit

An increase in an expense

An increase in an asset

A decrease in a liability

Credit

An increase in income

An increase in a liability

A decrease in an asset

Double entry bookkeeping

The rules of double entry bookkeeping are best learnt by considering the cash book.

A credit entry indicates a payment made by the business; the matching debit entry is then made in an account denoting an expense paid, an asset purchased or a liability settled

A debit entry in the cash book indicates cash received by the business; the matching credit entry is then made in an account denoting revenue received, a liability created or an asset realised

Journal

Format of journal entries is as follows.

Date		*Debit*	*Credit*
		$	$
DEBIT	A/c to be debited	X	
CREDIT	A/c to be credited		X

Narrative to explain transaction

Remember: the journal is used to keep a record of unusual movements between accounts

Journal entries are often required in an exam where you would not use the journal in practice, to save you the time that would be involved in drawing up 'T' accounts.

Imprest system

The double entry for topping up the petty cash is as follows:

		$	$
DEBIT	Petty cash	X	
CREDIT	Cash at bank		X

Day books

Note that day books are often analysed as in the following extract (date, customer name and reference not shown).

Total invoiced	*CD sales*	*Cassette sales*
$	$	$
340	160	180
120	70	50
600	350	250
1,060	580	480

To identify sales by product, total sales would be entered ('posted') as follows.

		$	$
DEBIT	Receivables a/c	1,060	
CREDIT	Sales: CDs		580
	Sales: Cassettes		480

Other books of prime entry are analysed in a similar way.

Trade accounts receivable and payable

Trade account receivable

A customer who buys goods without paying for them straight away (an asset).

Also known as a **debtor**.

Trade account payable

A person to whom a business owes money (a liability).

Also known as a **creditor**.

Receivables and payables ledgers

To keep track of individual customer and supplier balances it is common to maintain subsidiary ledgers called the receivables ledger and the payables ledger. Each account in these ledgers represents the balance owed by or to an individual customer or supplier.

Note that these receivables and payables ledgers are usually kept purely for reference and are therefore known as memorandum records. They do not form part of the double entry system.

However, some computerised accounting packages treat the receivables and payables ledgers as part of the double entry system, in which case separate control accounts are not kept.

Entries to the receivables ledger are made as follows.

- When making an entry in the sales day book, an entry is then made on the debit side of the customer's account in the receivables ledger
- When cash is received and an entry made in the cash book, an entry is also made on the credit side of the customer's account in the receivables ledger

The payables ledger operates in much the same way.

6: From the trial balance to financial statements

Topic List

- The trial balance
- The income statement
- The balance sheet
- Preparing financial statements

The balances need to be extracted from the ledger accounts and entered into the trial balance.

Double entry bookkeeping dictates that the trial balance will have the same amount on the debit side as there is on the credit side.

Trial balance

At the end of an accounting period a balance is struck on each ledger account.

- Total all debits and credits
- Debits exceed credits = debit balance
- Credits exceed debits = credit balance

The balances are then collected in a trial balance. If the double entry is correct, total debits = total credits.

An example of balancing a ledger account is shown below.

RECEIVABLES

	$		$
Sales	10,000	Cash	8,000
		Balance c/d	2,000
	10,000		10,000
Balance b/d	2,000		

Errors

A trial balance does not guarantee accuracy. It will not pick up the following errors.

- Compensating errors
- Errors of commission
- Errors of omission
- Errors of principle

An example of a trial balance, incorporating the above receivables balance, is shown below.

ABC TRADERS
TRIAL BALANCE AS AT 30 JUNE 20X7

	$	$
Sales		35,000
Purchases	13,000	
Receivables	2,000	
Payables		1,500
Cash	10,000	
Capital		10,000
Loan		10,000
Rent	4,000	
Sundry expenses	3,500	
Loan interest	1,000	
Drawings	5,000	
Fixtures and fittings	18,000	
	56,500	56,500

Income statement

First open up a ledger account for the income statement. Continuing our example, this ledger account is shown below, together with the rent account to illustrate how balances are transferred to it at the end of the year.

INCOME STATEMENT

	$		$
Purchases	13,000	Sales	35,000
Rent	4,000		
Sundry expenses	3,500		
Loan interest	1,000		

RENT

	$		$
Cash	4,000	I/S	4,000
	4,000		4,000

This could be re-arranged as follows to arrive at the financial statement with which you are familiar.

ABC TRADERS
INCOME STATEMENT
FOR THE YEAR ENDED 30 JUNE 20X7

	$	$
Sales		35,000
Cost of sales (here = purchases)		13,000
Gross profit		22,000
Expenses		
Rent	4,000	
Sundry expenses	3,500	
Loan interest	1,000	
		8,500
Net profit		13,500

Balance sheet (statement of financial position)

The balance sheet is prepared by following these steps

- Balance off the accounts relating to assets and liabilities following the receivables example shown above
- Transfer the balances on the drawings account and the income statement ($13,500) to the capital account as follows

DRAWINGS

	$		$
Cash	5,000	Capital	5,000

INCOME STATEMENT

	$		$
Purchases	13,000	Sales	35,000
Rent	4,000		
Sundry expenses	3,500		
Loan interest	1,000		
Capital a/c	13,500		
	35,000		35,000

CAPITAL

	$		$
Drawings	5,000	Cash	10,000
Balance c/d	18,500	I/S	13,500
	23,500		23,500

Remember to use the time available in an examination as efficiently as possible. If, for example, your balance sheet doesn't balance, quickly check your workings, but do *not* overrun on your time allocation for the question, and do *not* worry about it. Moving on to your next question will be a much more efficient use of your time.

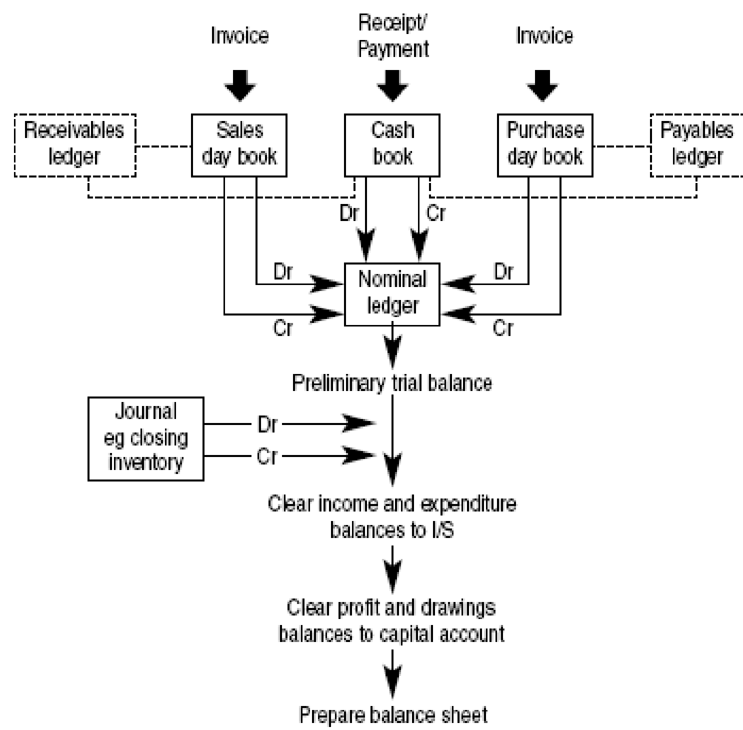
Prepare the statement of financial position (balance sheet) as follows

ABC TRADERS
BALANCE SHEET AS AT 30 JUNE 20X7

	$	$
Non-current assets		
Fixtures and fittings		18,000
Current assets		
Receivables	2,000	
Cash	10,000	
		12,000
		30,000
Proprietor's capital		18,500
Current liabilities		
Payables	1,500	
Loan	10,000	
		11,500
		30,000

Accounting process overview

This diagram summarises the topics you have revised so far. Look at it just before your exam – everything should fall into place.



7: Sales tax

Topic List

The nature of a sales tax and how it is collected
Accounting for a sales tax

A sales tax is a general consumer expenditure tax. It is likely to be examined as part of another topic.

Sales tax

Is an indirect tax levied on the sale of goods and services

Administered by tax authorities

Can have a number of rates, eg standard rate, reduced rate

Output sales tax

Sales tax charged by the business on goods/services

Greater than input?

Pay difference to tax authorities

Greater than output?

Refund due to business

Input sales tax

Sales tax on purchases made by the business

a Credit sales

(i) Include sales tax in sales day book; analyse it separately

(ii) Include gross receipts from receivables in cashbook; no need to show sales tax separately

(iii) Exclude sales tax element from income statement

(iv) Credit sales tax payable with output sales tax element of sales invoices

b Credit purchases

(i) Include sales tax in purchases day book; analyse it separately

(ii) Include gross payments in cashbook; no need to show sales tax separately

(iii) Exclude recoverable sales tax from income statement

(iv) Include irrecoverable sales tax in income statement

(v) Debit sales tax payable with recoverable input sales tax element of credit purchases

c Cash sales

(i) Include gross receipts in cashbook; show sales tax separately

(ii) Exclude sales tax element from income statement

(iii) Credit sales tax payable with output sales tax element of cash sales

d Cash purchases

(i) Include gross payments in cashbook: show sales tax separately

(ii) Exclude recoverable sales tax from income statement

(iii) Include irrecoverable sales tax in income statement

(iv) Debit sales tax payable with recoverable input sales tax element of cash purchases

8: Inventory

Topic List

- Cost of goods sold
- Accounting for opening and closing inventories
- Counting inventories
- Valuing inventories
- IAS 2

This is an important chapter, it covers a standard (IAS 2) and the complexities surrounding the inventory figure.

Remember, the inventory figure affects both the statement of financial position (balance sheet) and the income statement.

Formula for the cost of goods sold

	$
Opening inventory value	X
Add: purchases (or production costs)	X
	X
Less: closing inventory value	(X)
Cost of goods sold	X

Carriage inwards

- Cost paid by purchaser of having goods transported to his business
- Added to cost of purchases

Carriage outwards

- Cost to the seller, paid by the seller, of having goods transported to customer
- Is a selling and distribution expense

Entries during the year

During the year, purchases are recorded by the following entry.

DEBIT	Purchases	$ amount bought	
CREDIT	Cash or payables		$ amount bought

The inventory account is *not touched at all.*

Entries at year-end

The first thing to do is to transfer the purchases account balance to the income statement:

DEBIT	Income statement	$ total purchases	
CREDIT	Purchases		$ total purchases

The balance on the inventory account is still the *opening inventory* balance. This must also be transferred to the income statement:

DEBIT	Income statement	$ opening inventory	
CREDIT	Inventory		$ opening inventory

The exact reverse entry is made for the *closing inventory* (which will be next year's opening inventory):

DEBIT	Inventory	$ closing inventory	
CREDIT	Income statement		$ closing inventory

Counting inventories

In order to make the entry for the closing inventory, we need to know what is held at the year-end. We find this out *not* from the accounting records, but by going into the warehouse and actually counting the boxes on the shelves.

Some businesses keep detailed records of inventory coming in and going out, so as not to have to count everything on the last day of the year. These records are *not* part of the double entry system.

A dealer in, say, kitchen appliances, may know that he has 350 toasters at the year-end. He then needs to know what cash value to place on each toaster. This is the problem of valuation.

Prices

The price used to value an item of inventory might be any of a number of possibilities, eg selling price, replacement cost. However, we use the lower of the following.

- Cost
- The net realisable value (NRV): the expected selling price less future costs in getting the item ready for sale and then selling it

Identification rules

If we are using cost, and units have been bought at different prices during the year, we need to decide which items are left at the year-end. We apply a set rule, which may have nothing to do with the real order of use.

The examinable bases are:

FIFO: first in, first out
Average cost

Note. IAS 2 does not allow LIFO.

IAS 2

- Inventories should be measured at the lower of cost and net realisable value – the comparison between the two should ideally be made separately for each item
- Cost is the cost incurred in the normal course of business in bringing the product to its present location and condition, including production overheads and costs of conversion
- Inventory can include raw materials, work in progress, finished goods, goods purchased for resale
- FIFO and average cost are allowed
- LIFO is not allowed

Note: Inventory excludes construction contracts in progress (IAS 11), financial instruments (IASs 32 and 39), agricultural products (IAS 41) and mineral ores.

Inventories are assets:

– held for sale in the ordinary course of business

– in the process of production for such sale; or

– in the form of materials or supplies to be consumed in the production process or in the rendering of services.

Net realisable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

9: Tangible non-current assets

Topic List

- Capital and revenue expenditure
- Depreciation and revaluation
- Non-current asset disposals
- IAS 16
- The asset register

Non-current assets are held by the entity for a number of years use. Depreciation is the way that the non-current asset's useful life is represented in the financial statements.

You must be able to account for revaluations and disposals and to discuss IAS 16's main provisions.

You may be asked to explain the capital/revenue expenditure distinction in layman's terms

Capital expenditure results in the acquisition of non-current assets, or an increase in their earning capacity

Revenue expenditure is incurred for the purpose of trade or to maintain the existing earning capacity of the non-current assets

Depreciation

is a process of spreading the original cost of a non-current asset over the accounting periods in which its benefit will be felt.

- Depreciation is usually charged annually and appears as an expense in the income statement
- The annual charges are also accumulated in an allowance account in the balance sheet
- The credit balance on this account reflects the amount of the asset's original cost which has so far been written off

The annual depreciation charge on a non-current asset is based on two factors.

- The *depreciable amount* of the asset. This is the amount which must be written off over the entire life of the asset. It consists of the original cost less any estimated residual value
- The *estimated useful life* of the asset. This may be measured in terms of years or in terms of units of service provided by the asset

If an asset has to be revalued, the depreciation will be based on the revalued amount divided by the remaining useful life.

Capital and revenue expenditure | **Depreciation and revaluation** | Non-current asset disposals | IAS 16 | The asset register

The double entry for depreciation is as follows.

DEBIT Depreciation expense (I/S)
CREDIT Allowance for depreciation (B/S)

This reflects

- A periodic expense in the income statement
- A decrease in the asset's value in the balance sheet

Change in expected life

If after a period of an asset's life it is realised that the original useful life has been changed, then the depreciation charge needs to be adjusted.

The revised charge from that date becomes:

$$\frac{\text{NBV at revised date}}{\text{Remaining useful life}}$$

Revaluation

This is needed in order to reflect increases in asset values and is intended to provide a fairer view of the value of the business assets.

A revaluation is recorded as follows.

DEBIT Non-current asset
(revalued amount less original cost)

DEBIT Allowance for depreciation
(total depreciation to date)

CREDIT Revaluation reserve
(revalued amount less NBV)

Disposal

On disposal of an asset a profit or loss will arise depending on whether disposal proceeds are greater or less than the net book value of the asset.

- If proceeds > NBV = profit
- If proceeds < NBV = loss

You should note, however, that this profit or loss is not 'real' but simply an adjustment representing over or under depreciation during the asset's useful life.

Double entry for a disposal

- Eliminate cost

  DEBIT Disposals
  CREDIT Non-current assets

- Eliminate accumulated depreciation

  DEBIT Provision for depreciation
  CREDIT Disposals

- Account for sales proceeds

  DEBIT Cash
  CREDIT Disposals

  or if part exchange deal

  DEBIT Non-current assets
  CREDIT Disposals

  with part exchange value

- Transfer balance on disposals account to the income statement

IAS 16

IAS 16 *Property, plant and equipment* makes two important points.

- Depreciation is a measure of the wearing out or depletion of a non-current asset through use, time or obsolescence
- It is a means of allocating the cost of a non-current asset over its expected useful life, so matching cost with revenues earned during that life.

Factors to consider

- Cost of the non-current asset
  - Any amount incurred that is directly attributable to bringing the asset into working condition for its intended use
  - Includes such costs as delivery costs and solicitor's fees incurred relating to the asset's acquisition
- Useful economic life (to present owner)
- Residual value

Other considerations

Subsequent expenditure

Revaluation

Impairment

Obsolescence

With regard to disclosure, a proforma non-current asset note is shown here.

	Total	Land and buildings	Plant and equipment
	$'000	$'000	$'000
Cost or valuation			
At 1 January 20X7	160	100	60
Revaluation surplus	20	20	–
Additions in year	50	30	20
Disposals in year	(45)	(15)	(30)
At 31 December 20X7	185	135	50
Depreciation			
At 1 January 20X7	30	20	10
Charge for year	7	5	2
Eliminated on disposals	(3)	–	(3)
At 31 December 20X7	34	25	9
Net book value			
At 31 December 20X7	151	110	41
At 1 January 20X7	130	80	50

The asset register

Asset Code: 938		Next depreciation: 539.36
A	Description:	1 × Seisha Laser printer YCA40809
B	Date of purchase:	25/05/X6
C	Cost:	1618.25
D	Accumulated depreciation:	548.35
E	Depreciation %:	33.33%
F	Depreciation type:	straight line
G	Date of disposal:	NOT SET
H	Sale proceeds:	0.00
I	Accumulated depreciation amount:	55Q O/EQPT DEP CHARGE
J	Depreciation expense account:	34F DEPN O/EQPT
K	Depreciation period:	standard
L	Comments:	electronic office
M	Residual value:	0.00
N	Cost account:	65C O/E ADDITIONS

10: Intangible non-current assets

Topic List

Intangible non-current assets
Deferred development costs

Intangible non-current assets are long term assets with no physical substance. Here we cover the main intangibles:

- *Research costs*
- *Deferred development costs*

Intangible non-current assets

Non-current assets which have a value to the entity but no physical substance.

Examples

- Goodwill (see Chapter 19 on partnerships)
- Leases
- Patents and trade names
- Research and development costs

IAS 38 Intangible assets

- Pure or basic research
- Applied research

→ All costs written off as incurred

Development expenditure can sometimes be capitalised under special circumstances. All five criteria stated under IAS 38 must be fulfilled.

- Technical feasibility of completing the asset
- Intention to complete the asset
- Ability to use or sell the asset
- Generate probable future economic benefits
- Ability to measure the attributable expenditure

Capitalised development costs must be amortised systematically once commercial production begins. Each project must be reviewed annually to ensure deferral is still appropriate.

Amortisation

An intangible asset with an **indefinite** useful life is **not** amortised but should be reviewed each year for impairment.

Impairment

Development costs should be written down where they are no longer likely to be recovered from future economic benefits.

Disclosure

- Method of amortisation used
- Useful life of the assets or amortisation rate used
- Gross carrying value, accumulated depreciation and accumulated impairment losses at beginning and end of period
- Movements during the period
- Carrying amount of internally-generated intangible assets

11: Accruals and prepayments

Topic List

Accruals and prepayments

This chapter covers the adjustments which need to be made to expenses in order to reflect the true level of profits for the accounting period.

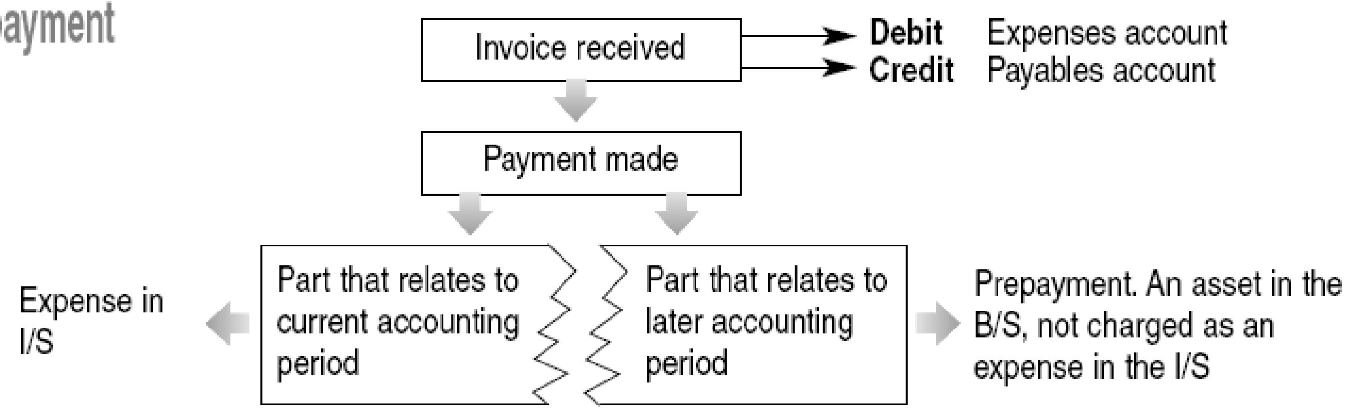
Accrual

Expenses charged against the profits of a period even though they have not yet been paid for

Prepayment

Payments made in one period but charged to the later period to which they relate

Prepayment



The amounted debited to the B/S will hit the I/S in the next period.

Accruals

Expense incurred – no invoice yet

Part relating to current accounting period is an accrual

Debit	I/S
Credit	B/S payables (liability)

Remember that the financial statements are prepared on an accruals basis and that accruals and prepayments are likely to feature in an accounts preparation question.

12: Irrecoverable debts and allowances

Topic List

This chapter looks at more adjustments required before the financial statements can be prepared.

Irrecoverable debts and receivables allowances

A receivable should only be classed as an asset if it is recoverable.

Irrecoverable debts

If definitely irrecoverable, the prudence concept (IAS 1) dictates that it should be written off to the income statement as an irrecoverable debt.

DEBIT	Irrecoverable debt expense (I/S)
CREDIT	Trade accounts receivable

Receivables allowances

If uncertainty exists as to the recoverability of the debt, prudence dictates that an allowance should be set up. This is offset against the receivables balance on the balance sheet.

DEBIT	Irrecoverable debt expense (I/S)
CREDIT	Allowance for receivables

Allowances can either be specific, against a particular receivable, or general, against a proportion of all receivables not specifically allowed for, based on past experience.

General allowances

When calculating the general allowance to be made, the following order applies.

		$
Receivables balance per receivables control account		X
Less:	irrecoverable debts written off	(X)
	amounts specifically allowed	(X)
Balance on which general allowance is calculated		X

Note. Only the *movement* in the general allowance needs to be accounted for.

	$
Allowance required	X
Existing allowance	(X)
Increase/(decrease) required	X/(X)

Subsequent recovery of debts

If a reduction in the receivables allowance is required, then:

DEBIT Allowance for receivables
CREDIT Irrecoverable debts expense (I/S)

If an irrecoverable debt is recovered, having previously been written off, then:

DEBIT Trade accounts receivable
CREDIT Irrecoverable debts expense

If the recovery is in a later accounting period, then the credit is to irrecoverable debts recovered.

13: Provisions and contingencies

Topic List

IAS 37

This standard is a key area of the syllabus. Learn how to apply it. The most important thing you should do is learn to justify the treatment you adopt.

Provision

A liability of uncertain timing or amount

Liability

An obligation of an entity to transfer economic benefits as a result of past transactions or events

Constructive obligation

An obligation that derives from an entity's actions where:

By an established pattern of past practice, published policies or a sufficiently specific current statement the entity has indicated to other parties that it will accept certain responsibilities.

As a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

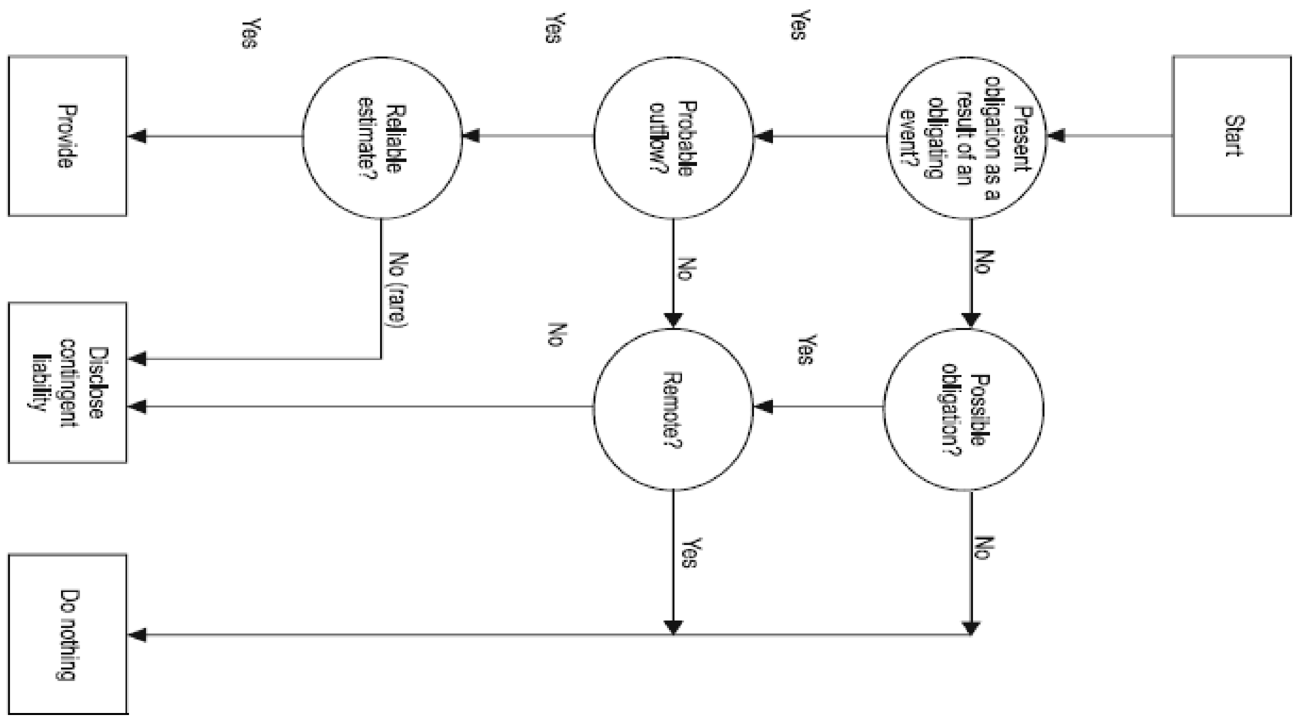
Important

The amount recognised as a provision should be the best estimate of the expenditure required to settle that present obligation.

Restructuring

A programme planned and controlled by management

Materially changes scope of business and/or the way the business is conducted


Start
Present obligation as a result of an obligating event?
Yes
No
Probable outflow?
Yes
No
Reliable estimate?
Yes
No (rare)
Provide
Possible obligation?
Yes
No
Remote?
No
Yes
Disclose contingent liability
Do nothing

Note. Restructuring is not usually triggered by a management decision alone. Other events, such as negotiations with employee representatives, need to take place.

Contingent Liability

A possible obligation that arises from past events, whose existence will be confirmed by the occurrence or non-occurrence of future events not wholly in the entity's control.

A present obligation not recognised because:

- It is not probable that settlement of the obligation will be required
- The amount cannot be measured.

Contingent Asset

A possible asset that arises from past events and whose existence will be confirmed by the occurrence of one or more uncertain future events not wholly within the entity's control.

14: Control accounts

Topic List

- What are control accounts?
- Discounts
- The operation of control accounts
- The purpose of control accounts

Control accounts help highlight human error.

You may have to prepare a control account in order to answer a MCQ in the exam.

What are control accounts

A control account is a *total* account.

- Its balance represents an asset or a liability which is the grand total of many individual assets or liabilities
- These individual assets/liabilities must be separately detailed in subsidiary accounting records, but their total is conveniently available in the control account ready for immediate use

Most businesses operate control accounts for trade receivables and payables, but such accounts may be useful in other areas too, eg sales tax.

With regard to the double entry relating to receivables and payables, note the following.

- The accounts of individuals are maintained *for memorandum purposes only*
- Entering a sales invoice, say, in the account of an individual receivable is not part of the double entry process

Discounts

A discount is a reduction in the price of goods or services

A supplier may have a *list* price at which he is prepared to provide his goods or services to the majority of customers. However, there may be reasons which justify a lower price or discount to particular customers or categories of customer.

It is useful to distinguish between three classes of discount

- *Trade discount* is granted to regular customers, usually those buying in bulk quantities
- *Cash discount* is granted to customers who are prepared to pay immediately in cash or by cheque, instead of purchasing on credit terms
- *Settlement discount* is granted to credit customers who pay within a specified period from the invoice date

Cash discount and settlement discount are similar in nature

- The cost of the discount to the supplier is in the nature of a financing charge, and this should be shown as an expense in the *income statement*
- Discounts received by the customer are a credit in the I/S

Trade discount is essentially different in nature

- It is genuinely a reduction in the selling price made in order to attract a higher level of business
- For this reason, it is accounted for as a reduction in the value of sales turnover or purchase cost shown in the *income statement*

The invoices in the sales day book are totalled periodically and the total amount is posted as follows.

DEBIT Receivables control account

CREDIT Sales account

Similarly, the total of cash receipts from receivables is posted from the cash book to the credit of the receivables control account.

In the same way, the payables control account is credited with the total purchase invoices logged in the purchase day book and debited with the total of cash payments to suppliers.

Reasons for maintaining control accounts

It is worth bearing in mind the main reasons for maintaining both individual accounts and a control account.

- The individual accounts are necessary for administrative convenience. For example, a customer may wish to query the balance he owes to the business; to deal with his query, receivables ledger staff would refer to his individual account
- The control accounts provide a convenient total which can be used immediately in extracting a trial balance or preparing accounts.
- A reconciliation between the control account total and the receivables ledger will help to detect errors, thus providing an important control

Proforma control account reconciliation

RECEIVABLES LEDGER CONTROL ACCOUNT

	$		$
Unadjusted balance b/f	X	Contra with payables ledger control a/c	X
Sales daybook Undercast	X	Discounts allowed not recorded	X
Dishonoured cheques	X	Transposition error	X
		Adjusted bal c/f	X
	X		X
Balance b/f	X		

TOTAL OF BALANCES EXTRACTED FROM RECEIVABLES LEDGER

		$
Original total		X
Add:	Debit balance on X Co's account extracted as credit balance (= credit balance × 2)	X
	Miscast of Y Co's account	X
	Z Co's balance omitted	X
Less:	Contra with payables ledger	(X)
	Irrecoverable debt written off	(X)
	Discounts allowed not recorded	(X)
Total as per amended control account		X

Note. Follow the same approach for payables ledger control account reconciliations.

It is the adjusted balance that appears in the final set of accounts.

Possible reasons for credit balances on receivables ledger accounts, or for debit balances on payables ledger accounts

- Overpayment of amount owed
- Return of goods
- Payment in advance
- Posting errors

15: Bank reconciliations

Topic List

- Bank statement and cash book
- Bank reconciliation

This area is not the most significant in the syllabus, but it will probably feature in most exams. With a small amount of practice you should be able to tackle any bank reconciliation thrown at you.

Bank reconciliation

A comparison of a bank statement with the cash book.

The bank reconciliation is an important financial control.
The bank reconciliation will invariably show a difference.

Differences on bank reconciliation

Errors: more likely in the cash book.

Omissions: items on the bank statement not in the cash book (e.g. bank charges)

Timing differences: eg cheques issued and entered in the cash book but not yet presented at the bank.

Proforma bank reconciliation

CASH ACCOUNT

	$		$
Balance b/f	X	Dishonoured cheque	X
		Bank charges	X
		Standing orders	X
Undercast error		Direct debits	X
in balance b/f	X	Balance c/f	X
	X		X
Adjusted balance b/f	X		

	$
Balance per bank statement	X
Less: outstanding cheques	(X)
Plus: outstanding lodgements	X
Plus/less: bank errors	X/(X)
Balance per adjusted cash account	X

16: Correction of errors

Topic List

Types of error in accounting

The correction of errors

There will always be errors which need to be corrected before the final accounts can be prepared.

It helps to know what kind of errors can be made in order that you can find them and then correct them.

Types of error

The main types of error are as follows

- Errors of transposition, eg writing \$381 as \$318 (the difference is divisible by 9)
- Errors of omission, eg receive supplier's invoice for \$500 and do not record it in the books at all
- Errors of principle, eg treating capital expenditure as revenue expenditure
- Errors of commission, eg putting telephone expenses of \$250 in the electricity expense account
- Compensating errors, eg both sales day book and purchases day book coincidentally undercast by \$500

Correction of errors

Errors can be corrected using the journal, but only those errors which required both a debit and an (equal) credit adjustment. Consider the following examples

Example

Accountant omits to record invoice from supplier for $2,000. This would be corrected by the following journal entry.

DEBIT	Purchases	$2,000	
CREDIT	Payables		$2,000

A transaction previously omitted.

Example

Accountant posts car insurance of $800 to motor vehicles account. Correct as follows.

DEBIT	Motor expenses	$800	
CREDIT	Motor vehicles		$800

Correction of error of principle.

A suspense account is a temporary account that is used in the following circumstances.

- The bookkeeper knows in which account to make the debit entry for a transaction but does not know where to make the corresponding credit entry (or vice versa)
- The credit is temporarily posted to the suspense account until the correct credit entry is known
- A difference occurs in the trial balance caused by the incomplete recording of the double entry in respect of one or more transactions
- The difference is recorded in the suspense account and included in the trial balance, so restoring equality

Any balance on a suspense account must be eliminated. It is *never* included in the final accounts.

Example

Harry Perkins, sole trader, prepared his trial balance for the year ended 30 June 20X5. To his dismay he found that debits exceeded credits by $7,452.

He has discovered the following errors.

1. Discounts allowed of $486 were posted to the discounts allowed account as $684
2. Credit sales totalling $7,500 had not been posted to the sales account
3. The balance on the accruals account of $404 had been omitted when the trial balance was prepared
4. In respect of telephone expenses of $650, the only entry to have been made was in the cash account.

The balance would be cleared by writing up the suspense account as follows.

SUSPENSE ACCOUNT

	$		$
Discounts allowed (1)	198	B/d	7,452
Sales (2)	7,500	Telephone (4)	650
Accruals (3)	404		
	8,102		8,102

			$	$
(1)	The correct entry:			
	DEBIT	Discounts allowed	486	
	CREDIT	Receivables		486
	The actual entry:			
	DEBIT	Discount allowed	684	
	CREDIT	Receivables		486
	∴ CREDIT	Suspense (balance)		198
	To correct:			
	DEBIT	Suspense	198	
	CREDIT	Discounts allowed		198

			$	$
(2)	The correct entry:			
	DEBIT	Receivables	7,500	
	CREDIT	Sales		7,500
	The actual entry:			
	DEBIT	Receivables	7,500	
	∴ CREDIT	Suspense		7,500
	To correct:			
	DEBIT	Suspense	7,500	
	CREDIT	Sales		7,500
(3)	To correct:			
	DEBIT	Suspense	404	
	CREDIT	Accruals		404
(4)	To correct:			
	DEBIT	Telephone	650	
	CREDIT	Suspense		650

With suspense accounts, you must think carefully about the double entry. Provided you work logically through the following steps, you should be able to tackle these fairly easily.

Step 1. **What is the correct entry?**

Step 2. **What is the actual entry?**

Step 3. **Calculate the entry needed to correct the error**

Remember IAS 8 treatment of material errors, you may need to adjust prior years (see Chapter 3 of these passcards).

17: Preparation of financial statements for sole traders

Topic List

Preparation of final accounts

Sole trader's accounts are usually prepared from a final balance.

Assessments may include adjustments (eg for irrecoverable debts) or clearing a suspense account.

Final accounts

You have now revised all areas necessary to prepare the final accounts of a sole trader. Areas you should be totally familiar with are as follows.

- Ledger accounts
- Trial balance
- Format of income statement and statement of financial position (balance sheet)

In addition, you should be able to deal with the following adjustments.

Depreciation
Inventory
Accruals and prepayments
Irrecoverable debts
Allowance for receivables
Profit/loss disposal of non-current assets

18: Incomplete records

Topic List

- Opening position
- Credit sales, purchases and cost of sales
- Stolen or destroyed goods
- Cash book
- Accruals, prepayments and withdrawals

This area is a very good test of your accounts preparation knowledge.

You need to know how the accounts fit together in order to fill the blanks.

Types of question

An incomplete records question may require competence in dealing with one or more of the following.

- Preparation of accounts from information in the question
- Theft of cash (balance on the cash in hand account is unknown)
- Theft or destruction of inventory (closing inventory is the unknown)
- Estimated figures, eg 'drawings are between $15 and $20 per week'
- Calculation of capital by means of net assets
- Calculation of profit by P = increase in net assets plus drawings minus increase in capital
- Calculation of year end inventory when the inventory was done after the year end

Opening position

- Often an examination question provides information about the assets and liabilities of an entity at the beginning of a period, leaving you to calculate capital as the balancing figure.
- Remember

  Assets – liabilities = Proprietor's capital

- If you have opening and closing net assets, you can calculate profit for the year by the use of the business equation:

  $P = I + D - Ci$

Note: the examiner is currently using the term 'drawings' rather than 'withdrawals'. They are synonymous.

Credit sales and receivables

- The key lies in the formula linking sales, cash receipts and receivables.
- Remember

  Opening receivables + sales – cash receipts = closing receivables
- Alternatively put all the workings into a control account to calculate the figure you want.

Purchases and trade accounts payables

- Similarly you need a formula for linking purchases, cash payments and payables.

  Opening payables + purchases – cash payments = closing payables
- Use a control account.

RECEIVABLES CONTROL ACCOUNT

	$		$
Opening receivables	X	Cash receipts	X
Sales	X	Closing receivables	X
	X		X

PAYABLES CONTROL ACCOUNT

	$		$
Cash payments	X	Opening payables	X
Closing payables	X	Purchases	X
	X		X

Gross margins and mark ups

Other incomplete records problems revolve around the relationship between sales, cost of sales and gross profit: in other words, they are based on reconstructing a trading account. Bear in mind the crucial formula:

		%
	Cost of sales	100
Plus	Gross profit	25
Equals	Sales	125

Gross profit may be expressed either as a percentage of cost of sales or as a percentage of sales.

- In the example, gross profit is 25% of cost of sales (ie 25/100). The terminology is a 25% *mark up*
- Gross profit can also be expressed as 20% of sales (ie 25/125). The terminology is a 20% gross margin or *gross profit percentage*. The proforma would appear as follows.

		%
	Cost of sales	80
Plus	Grossprofit	20
Equals	Sales	100

Stolen goods or goods destroyed

The cost of goods stolen/destroyed can be calculated as follows.

	$
Cost of goods sold based on gross profit margin or mark up	A
Cost of goods sold calculated using standard formula	
(ie opening inventory plus purchases less closing inventory)	(B)
Difference (lost/stolen inventory)	C

- If no goods have been lost, A and B should be the same and therefore C should be nil
- If goods have been lost, B will be larger than A, because some goods which have been purchased were neither sold nor remaining in inventory, ie they have been lost
- Stolen or lost inventory is accounted for in two ways depending on whether the goods were insured

If insured		If not insured	
DEBIT	Insurance claim (receivable)	DEBIT	I&E account
CREDIT	Trading account	CREDIT	Trading account

Cash book

Incomplete records problems often concern small retail entities where sales are mainly for cash. A two-column cash book is often the key to preparing final accounts.

- The bank column records cheques drawn on the business bank account and cheques received from customers and other sources
- The cash column records till receipts and any expenses or drawings paid out of till receipts before banking

Debits (receipts)		Credits (payments)	
Cash	Bank	Cash	Bank
$	$	$	$

Don't forget that movements between cash and bank need to be recorded by contra entries. This will usually be cash receipts lodged in the bank (debit bank column, credit cash column), but could also be withdrawals of cash from the bank to top up the till (debit cash column, credit bank column).

Again, incomplete records problems will often feature an unknown figure to be derived. Enter in the credit of the cash column all amounts known to have been paid from till receipts: expenses, withdrawals, lodgements into bank. Enter in the debit of the cash column all receipts from cash customers or other cash sources.

- The balancing figure may then be a large debit, representing the value of cash sales if that is the unknown figure
- Alternatively it may be a credit entry that is needed to balance, representing the amount of cash withdrawals or of cash stolen

Accruals and prepayments

When there is an accrued expense or prepayment, the I/S charge can be calculated from the opening balance, the cash movement and the closing balance.

Sometimes it helps to use a 'T' account, eg as follows (for a rent payment).

RENT

	$		$
Prepayment: bal b/f	700	I/S (bal fig)	9,000
Cash	9,300	Prepayment: bal c/f	1,000
	10,000		10,000

Withdrawals (Drawings)

Note three tricky points about withdrawals.

- Owner pays personal income into business bank account

  DEBIT Cash
  CREDIT Withdrawals

- Owner pays personal expenses out of business bank account

  DEBIT Withdrawals
  CREDIT Cash

- Wording of an exam question
  - 'Withdrawals approximately $40 per week'
    ∴ Withdrawals for year = $40 × 52 = $2,080
  - 'Withdrawals between $35 and $45 per week'
    ∴ Withdrawals are a missing number to be calculated

Step by step approach

1 Find opening balances - may need to find opening capital using the accounting equation

Net assets = proprietor's interest

Fill in the opening balances wherever possible, either directly onto the balance sheet and income statement or into workings.

2 Set out the following (as far as possible

- Income statement
- Statement of financial position (balance sheet)

Work through the question line by line, putting the information in the accounts, including the balance sheet. Tick off on the question paper and leave any difficult bits until the end. *Ensure that the double entry is maintained*.

3 Open 'T' accounts

- Cash account or two column cash book
- Bank account or two column cash book
- Receivables control account
- Payables control account

When this step is complete, assess the answer for gaps and fill them in using workings for balancing figures (eg cash account, receivables, payables) and a cost structure if necessary (eg purchases, sales).

Tidy up the income statement and statement of financial position (balance sheet).

19: Partnerships

Topic List

- Characteristics of partnerships
- Preparing partnership accounts

This section looks at a business-type with more than one owner.

You need to know how to prepare a partnership's accounts and what advantages/disadvantages there are to this business-type compared with the sole trader.

Partnership agreement

A partnership is an arrangement between two or more individuals in which they undertake to share the risks and rewards of a joint business operation.

The financial arrangements agreed between the partners are often set out in a formal document called a *partnership agreement*.

Advantages of partnership

Partnership v sole trader

- Spread risk
- Network of contacts
- Partners bring in business, skills and experience
- Easier to raise finance

Partnership v limited liability company

- No need to comply with statutory requirements such as audit
- No need to comply with accounting standards
- No formation or registration fees

However, note the following disadvantages.

Partnership v sole trader:

- Profits spread
- Dilution of control
- Disputes between partners

Partnership v limited liability company:

- No limited liability

Capital and current accounts

It is usual to maintain both a capital account and a current account for each partner.

A partner's capital account shows any cash or other assets brought by him into the business. He will usually make an initial capital contribution when he joins the partnership, but there may also be further injections (or withdrawals) of capital later on.

While the balance on a partner's capital account is likely to remain stable for long periods, his current account balance will fluctuate more rapidly.

- He will draw money regularly from the business to support his living expenses and these drawings will be debits to his current account
- He will be entitled to a share of the business profits and this will be credited to his current account at least annually

PROFORMA CURRENT ACCOUNT

	X	*Y*	*Z*		*X*	*Y*	*Z*
	$	$	$		$	$	$
Drawings	X	X	X	Salary	X	X	X
Interest on drawings	X	X	X	Interest on capital	X	X	X
Balance c/f	X	X	X	Profit share	X	X	X
	X	X	X		X	X	X

Appropriation accounts

In the case of a sole trader, retained profits earned each year are simply added to his capital balance. With a partnership, things are more complicated.

After calculating the net profit earned by the business, an appropriation account must be prepared to determine the allocation of profit between the partners.

To discourage excessive drawings partners often agree to charge themselves interest on any sums withdrawn from the business.

Such interest is charged to the partner concerned (ie debited to his current account) and credited to the appropriation account, increasing the profit available for sharing between the partners.

The sum available for appropriation must now be shared amongst the partners and credited to their current accounts.

- Some partners may be entitled to a salary. This is credited to the partner concerned and taken out of the 'pool' available for appropriation
- Partners may be entitled to interest on their capital account balances. Each partner is credited with the appropriate amount and again the 'pool' is reduced
- Finally, the residual 'pool' of profits is shared amongst the partners in their profit sharing ratio

PROFORMA APPROPRIATION ACCOUNT

			$	$
Net profit				X
Add interest on drawings				
A			X	
B			X	
C			X	
				X
				X
Less:	salary A		X	
	interest on capital:	A	X	
		B	X	
		C	X	
				(X)
Profit				X
Appropriation:		A	X	
		B	X	
		C	X	
				X

Loans by partners

When a partner makes a loan to the partnership he is a creditor of the partnership. The loan is shown separately from the partners' capital as a long-term liability.

Remember:

Interest on a partner's loan is a I/S expense not an appropriation. However, the interest is added to the partner's current account.

Goodwill

- Goodwill arises on the admission or retirement of partners
- Bring in the goodwill to the old partners in the old PSR

  Debit goodwill
  Credit current accounts of partners

- Write back the goodwill to the new partners in the new PSR

  Debit current accounts of partners
  Credit goodwill

20: Introduction to company accounting

Topic List

- Limited liability companies
- Shares
- Reserves
- Bonus and rights issues

This section looks at the basics of limited liability companies and how they differ from sole traders and partnerships.

Limited liability companies | Shares | Reserves | Bonus and rights issues

Features

Limited liability companies offer limited liability to their owners (shareholders). If the company becomes insolvent, the maximum amount that an owner stands to lose is his share of the capital of the business. This is an attractive prospect to investors. Limited liability companies may be private or public. IAS 1 sets out a suggested format for financial statements.

- Owners = shareholders or members
- Large number of owners
- Owner/manager split
- Owners appoint directors to run business on their behalf
- Owners receive share of profits in form of dividends

Disadvantages

- Compliance with national legislation
- Compliance with national accounting standards and/or IFRS
- Any formation or annual registration costs

Funding

Companies are funded in the following ways:

- Retained profits
- Short term liabilities (trade accounts payable etc)
- Share capital
- Loan notes

Shares

The proprietors' capital in a limited liability company consists of share capital. When a company is set up for the first time it issues shares, which are paid for by investors, who then become shareholders of the company.

Shares are denominated in units of 25 cents, 50 cents, $1 or whatever seems appropriate. This is referred to as their nominal value.

Preferred shares are characterised as follows

- Rights depend on articles
- Right to fixed dividend with priority over ordinary shares
- Do not usually carry voting rights
- Generally priority for capital in winding up
- May be redeemable (loan) or irredeemable (equity)

Ordinary shares have the following characteristics

- No right to fixed dividend
- Entitled to remaining profits after preferred dividend
- Entitled to surplus on repayment of capital

Share capital

- *Authorised.* The maximum amount of share capital that a company is empowered to issue
- *Issued.* The amount of share capital that has been issued to shareholders. The amount of issued capital cannot exceed the amount of authorised capital
- *Called up.* When shares are issued or allotted, a company does not always expect to be paid the full amount of the issue price at once. it might instead call up only a part of the issue price, and call up the remainder later
- *Paid-up.* Called up capital that has been paid.
- *Market value.* This is the price at which someone is prepared to purchase the share value from an existing shareholder. It is different from nominal value

The following are the main types of share issue:

- New issue at par or at a premium
- Bonus/scrip/capitalisation issue
- Rights issue

Loan notes

Companies may issue loan notes. These are long term liabilities not capital. They differ from shares as follows:

- Shareholder = owner; noteholder = payable
- Loan note interest *must* be paid; not so dividends
- Loan notes often secured on company assets

Reserves

Revenue reserves consist of distributable profits and can be paid out as dividends

- Revenue reserve
- Others, as the directors decide, eg general reserve

Capital reserves are not available for distribution. They include the following:

- *Share premium.* Whenever shares are issued for a consideration in excess of their nominal value, such a premium shall be credited to a share premium account
- Share premium account can be used to
  - Issue bonus shares
  - Write off formation expenses and premium on the redemption of shares and loan notes
  - Write off the expenses on a new issue of shares/loan notes and the discount on the issue of loan notes
- *Revaluation reserve.* Created when a company revalues one or more of its non-current assets
- *Statutory reserves.* The law requires the company to set up these

Bonus issues

A bonus (or capitalisation) issue uses reserves to pay for the issue of share capital.

Example

Issue of 5,000 new $1 shares

Debit Reserves (share premium or retained earnings)	$5,000
Credit Share capital	$5,000

Rights issue

A rights issue enables existing shareholders to acquire further shares.

Example

Issue of 5,000 new $1 shares at $1.50 per share

Debit Cash	$7,500
Credit Share capital	$5,000
Credit Share premium	$2,500

21: Preparation of financial statements for companies

Topic List

- IAS 1
- IAS 18

This section looks at limited liability company accounts.

Limited liability company accounts are more comprehensive as there are more stakeholders who wish to know how the business is doing.

ABC CO
STATEMENT OF FINANCIAL POSITION (BALANCE SHEET)
AS AT 31 DECEMBER 20X2

	20X2		*20X1*	
	$	$	$	$
Assets				
Non-current assets				
Property, plant and equipment	X		X	
Goodwill	X		X	
Manufacturing licences	X		X	
Investments in associates	X		X	
Other financial assets	X		X	
		X		X
Current assets				
Inventories	X		X	
Trade and other receivables	X		X	
Prepayments	X		X	
Cash and cash equivalents	X		X	
		X		X
Total assets		X		X

ABC CO
STATEMENT O FINANCIAL POSITION (BALANCE SHEET)
AS AT 31 DECEMBER 20X2 (cont)

	20X2		*20X1*	
	$	$	$	$
Equity and liabilities				
Equity				
Issued capital	X		X	
Reserves	X		X	
Retained earnings/(losses)	X		X	
		X		X
Minority interest		X		X
Total equity		X		X
Non-current liabilities				
Issued capital	X		X	
Reserves	X		X	
Retained earnings/(losses)	X		X	
		X		X
Current liabilities				
Trade and other payables	X		X	
Short-term borrowings	X		X	
Current portion of interest-bearing borrowings	X		X	
Warranty provision	X		X	
		X		X
Total equity and liabilities		X		X

ABC CO
INCOME STATEMENT
FOR THE YEAR ENDED 31 DECEMBER 20X2

	20X2	*20X1*
	$	$
Revenue	X	X
Cost of sales	(X)	(X)
Gross profit	X	X
Other income	X	X
Distribution costs	(X)	(X)
Administrative expenses	(X)	(X)
Other expenses	(X)	(X)
Finance cost	(X)	(X)
Profit before tax	X	X
Income tax expense	(X)	(X)
Profit for the year	X	X

IAS 18 Revenue

Recognition

Recognition occurs when it is probable that future economic benefits will flow to the entity and when these benefits can be measured reliably.

IAS 18 covers revenue from

- Sale of goods
- Rendering of services
- Use by others of entity assets yielding interest, royalties and dividends

Measurement

The amount of revenue is usually decided by the agreement of buyer and seller. However, the revenue is **measured** as the fair value of the consideration received, ie after trade and bulk discounts.

22: Events after the reporting period (balance sheet date)

Topic List

IAS 10

This standard is a key area of the syllabus. Learn how to apply it. The most important thing you should do is learn to justify the treatment you adopt.

EVENTS AFTER THE REPORTING PERIOD (BALANCE SHEET DATE)
Occur between the balance sheet date and the date on which the financial statements are authorised for issue.

ADJUSTING EVENTS
Provide additional evidence of conditions existing at the balance sheet date.

NON-ADJUSTING EVENTS
Concern conditions which did not exist at the balance sheet date.

STANDARD ACCOUNTING
Change the figures in the financial statements if the event is material and either it is an adjusting event or the going concern concept is no longer appropriate.

STANDARD ACCOUNTING
Disclose an event in a note if it is material and is a non-adjusting event.

EVENTS AFTER AUTHORISATION OF THE ACCOUNTS
The directors should consider publishing these if material.

Examples

Adjusting events	Non adjusting events
▪ Non-current assets. Determination of purchase price or proceeds of sale	▪ Mergers and acquisitions
▪ Property and investments. Evidence of a permanent impairment	▪ Reconstructions
▪ Inventories. Evidence of NRV or likely profits/losses on long-term contracts	▪ Issues of shares and debentures
▪ Receivables. Renegotiation by or insolvency of trade accounts receivable	▪ Purchases/sales of non-current assets and investments
▪ Settlement of insurance claims.	▪ Loss or drop in value of non-current assets or inventories occurring after the year end
▪ Discoveries of error or fraud	▪ Expansion or contraction of trade
▪ Taxation. Rates fixeddate	▪ Changes in rates of foreign exchange
	▪ Government action or strikes
	▪ Augmentation of pension benefits
	▪ Dividends declared after the balance sheet date

23: Statements of cash flows

Topic List

Profit is not the same as cash. The statement of cash flows allows us to assess the quality of profit. How quickly does the profit figure get translated into a healthy cash balance?

It is possible for a profitable firm to collapse due to poor cash flows.

Purpose

A statement of cash flows shows the effect of an entity's commercial transactions on its cash balance.

It is thought that users of accounts can readily understand cash flows, as opposed to income statements and balance sheets, which are subject to manipulation by the use of different accounting policies.

Cash flows are used in investment appraisal methods such as net present value and hence a cash flow statement gives potential investors the chance to evaluate a business.

Format

IAS 7 *Statements of cash flows* splits cash flows into the following headings:

- Cash flows from operating activities
- Cash flows from investing activities
- Cash flows from financing activities

The IAS requires a reconciliation of cash and cash equivalents.

STATEMENT OF CASH FLOWS
YEAR ENDED 20X7

	$m	$m
Cash flows from operating activities		
Net profit before taxation	3,390	
Adjustments for:		
Depreciation	450	
Investment income	(500)	
Interest expense	400	
Operating profit before working capital changes	3,740	
Increase in trade and other receivables	(500)	
Decrease in inventories	1,050	
Decrease in trade payables	(1,740)	
Cash generated from operations	2,550	
Interest paid	(270)	
Income taxes paid	(720)	
Net cash from operating activities		1,560
Cash flows from investing activities		
Purchase of property, plant and equipment	(900)	
Proceeds from sale of equipment	20	
Interest received	200	
Dividends received	200	
Net cash used in investing activities		(480)

STATEMENT OF CASH FLOWS
YEAR ENDED 20X7 (cont)

	$m	$m
Cash flows from financing activities		
Proceeds from issuance of share capital	250	
Proceeds from long-term borrowings	250	
Dividends paid *	(1,290)	
Net cash used in financing activities		(790)
Net increase in cash and cash equivalents		290
Cash and cash equivalents at beginning of period (Note)		120
Cash and cash equivalents at end of period (Note)		410

* This could also be shown as an operating cash flow

Note: Cash and cash equivalents consist of cash on hand and balances with banks, and investments in money marketing instruments. Cash and cash equivalents included in the cash flow statement comprise the following balance sheet amounts.

	20X7	*20X8*
	$m	$m
Cash on hand and balances with banks	40	25
Short-term investments	370	95
Cash and cash equivalents	410	120

The company has undrawn borrowing facilities of $2,000, of which only $700 may be used for future expansion.

The above proforma was for the *indirect method*. The *direct method* proforma is the same except for the first part which appears as follows.

	$	$
Cash receipts from customers	X	
Cash paid to suppliers and employees	(X)	
Cash generated from operations		X
Interest paid		(X)
Income taxes paid		(X)
Net cash from operating activities		X

Examination questions will probably require the indirect method. If the direct method is required, the necessary information will be given to you.

Technique

The following step by step technique should be adopted in questions on cash flow statements:

- Set out the proforma leaving plenty of space
- Complete the reconciliation of operating profit to net cash inflow, as far as possible
- Calculate the following where appropriate
  - Tax paid
  - Dividends paid
  - Purchase and sale of non-current assets
  - Issue of shares
  - Repayment of loans
- Work out the profit if not already given using
  - Opening and closing balances
  - Tax charge
  - Dividends
- Slot the figures into the statement
- Complete the note of cash and cash equivalents
- Complete the statement

Advantages

- Business survival needs cash
- Cash flow is more objective than profit
- Trade accounts payable need to know if they will be paid
- More comparability between entities
- Better basis for decision making
- Easy to understand, prepare and audit

Disadvantages

- The disadvantages of cash flow accounting are basically the opposite of advantages of accruals accounting,
- For example, cash flow does *not* match income and expenditure in the income statement.

Criticisms of IAS 7

- Inclusion of cash equivalents does not reflect the way businesses are managed
- The requirement that a cash equivalent has to be within three months of maturity is unrealistic
- Management of cash equivalents is not distinguished from other investment decisions

24: Information technology

Topic List

- Accounting packages
- Accounting modules
- Databases

A computerised accounting system is governed by the same accounting principles as a manual system.

Make sure you learn the advantages and disadvantages of computer packages.

Accounting packages | Accounting modules | Databases

Advantages

- Can deal with large volumes of transactions very quickly
- Rapid analysis of data to provide useful output, eg, invoices, ETB, receivables reports
- Integration of system/modules prevents repetition as one entry updates several records
- Improved accuracy
- Operators can be non-specialists as use of codes for input means correct accounts will be updated

Disadvantages

- Danger of unauthorised access to files
- Danger of data corruption
- Chance of incorrect inputs
- 'Invisible' data
- Time and cost of installation, training and developing a coding system

An accounting module is a program which deals with one part of a business accounting system.

Most accounting packages will consist of several modules: a suite.

A suite may consist of:

- Invoicing
- Inventory
- Receivables ledger
- Payables ledger
- Nominal ledger
- Payroll
- Cash book
- Job costing
- Asset register
- Report generator

Examples

Receivables ledger keeps track of sales made and payments received. Record is kept for each customer. Master file updated with transactions data.

Payables ledger keeps track of purchases and payments made for them. Record kept for each supplier.

Payroll system records details for each employee and computes the amounts to be paid on each payday.

Databases

- A file or pool of data structured to serve a number of applications.
- Variety of uses within the enterprise, not restricted to the accounting function. (A file of employee details may be used by both payroll and personnel.)
- Run by a database management system (DBMS) which deals with the organisation and retrieval of information from discrete files within a system.